

Comments

SEC and FRB Treatment of Options: An Experiment in Market Regulation

George Lee Flint, Jr.

After five years in the planning stage, the Chicago Board Options Exchange (CBOE), on April 26, 1973, commenced operation for a pilot period.¹ The CBOE, the nation's first exchange devoted exclusively to options trading and the first to trade options since the passage² of the Securities Exchange Act of 1934,³ potentially represents the most significant development in the securities industry since the introduction of mutual funds. The genesis of a new investment market capable of generating new commissions for the brokerage industry,⁴ coupled with the CBOE's early success in attracting investors,⁵ has interested several national exchanges—most notably the American Stock Exchange and the PBW Stock Exchange.⁶ The CBOE's debut has also attracted the

1. Berton, *Options Trading: A Booming New Market*, FINANCIAL WORLD, June 20, 1973, at 25. The Chicago Board of Trade approved in principle the formation of an affiliate options exchange in October 1971. Wall St. J., Oct. 20, 1971, at 4, col. 4. The Securities and Exchange Commission approved the registration of the options exchange on February 1, 1973. SEC Securities Exchange Act Release No. 9985 (Feb. 1, 1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,212.

2. See Gates, *The Developing Option Market: Regulatory Issues and New Investor Interest*, 25 U. FLA. L. REV. 421, 421-31 (1973).

3. Securities Exchange Act of 1934, 15 U.S.C. §§ 78 *et seq.* (1970).

4. See *The Big Action in Options*, DUNS, Oct. 1973, at 57.

5. Prior to the creation of the CBOE, the Put and Call Brokers and Dealers Association sold at most four thousand contracts per week in the over-the-counter market. Berton, *supra* note 1. During October 1973 alone, CBOE trading nearly equalled over-the-counter volume for all of 1972. *Option Plays Are Spreading*, BUS. WEEK, Dec. 22, 1973, at 104. By March 1974 volume on the exchange averaged 16,800 contracts per day. Laing, *New Game in Town*, Wall St. J., April 22, 1974, at 1, col. 6. The CBOE achieved this spectacular record despite a declining market. *Id.* In the rising market of May 1975 the CBOE's volume reached 63,000 contracts per day. Wall St. J., May 14, 1975, at 21, col. 1. Such a large increase, however, falls far short of the New York Stock Exchange's volume of 250,000 100-share blocks traded daily.

6. *Option Plays Are Spreading*, *supra* note 5; Turov, *New Look in Calls*, 53 BARRON'S, Aug. 6, 1973, at 9. The SEC has recently permitted the American Stock Exchange to engage in options trading. SEC Securities Exchange Act Release No. 11,144 (Dec. 19, 1974), [Current Binder] CCH FED. SEC. L. REP. ¶ 80,034 (1974). The PBW Stock Exchange received tentative approval to begin options trading on June 1, 1975. Wall St. J., March 21, 1975, at 4, col. 2. PBW does not yet list options, as do CBOE and AMEX.

attention of the Securities and Exchange Commission (SEC) and the Federal Reserve Board (FRB), both of which Congress has ordained to protect the investor and assure a fair market.⁷

The development of a substantial options market poses special risks to investors and to the securities market.⁸ Failing to understand the market mechanics, the investor risks encountering more precipitous losses in options than in other securities trading. Furthermore, both the instability of options prices and the dislocation of credit reserves caused by heavy speculation in options threaten other securities markets. To protect the investor and ensure a climate of fairness and economic efficiency, both the SEC and the FRB have recently moved to curb the unfavorable effects of options trading. The SEC, having perceived the posture of options trading in the larger securities market and its particular suitability to experimentation,⁹ has fashioned a number of innovative and potentially far-reaching proposals. It has promulgated rule 9b-1,¹⁰ describing the SEC's power to formulate rules for options exchanges; proposed rule 9b-2,¹¹ pertaining to disclosure and suitability requirements for options trading; and proposed rule 238,¹² providing an exemption from options registration. The FRB, meanwhile, has modified its margin requirements to make certain that options have no loan value,¹³ purportedly to prevent misallocation of the nation's credit reserves. This comment evaluates the wisdom and effectiveness of the agencies' recent custodial démarche.

I. The Mechanics of Options Trading

The two fundamental types of options,¹⁴ the call and the put, grant the holder the right to purchase (call) or sell (put) the underlying stock at a specified price, the striking price, at any time within the con-

7. See Securities Exchange Act of 1934 § 7, 15 U.S.C. § 78g (1970).

8. See Proposal to Adopt Rule 9b-1, SEC Securities Exchange Act Release No. 34-9930 (Jan. 9, 1973), 38 Fed. Reg. 1646 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,171.

9. E.g., SEC Securities Exchange Act Release No. 10,552 (Dec. 13, 1973), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,604.

10. 17 C.F.R. § 240.9b-1 (1974).

11. Proposed SEC Reg. § 240.9b-2, 38 Fed. Reg. 35,334 (1973), 2 CCH FED. SEC. L. REP. ¶ 22,623 (1973).

12. SEC Securities Exchange Act Release No. 5444 (Dec. 13, 1973), 39 Fed. Reg. 1283 (1974), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,602.

13. 12 C.F.R. § 220.126 (1975).

14. For discussion of options investment strategies, see B. MALKIEL & R. QUANDT, STRATEGIES AND RATIONAL DECISIONS IN THE SECURITIES OPTIONS MARKET 34-72 (1969).

tract period. The striking price usually approaches the underlying stock's market value at the time of the sale of the call or put.

The capital outlay for options investing is much less than the requisite investment for trading in the underlying stock, in that the price paid for the option, the premium, typically equals only a small percentage of the striking price. Suppose, for example, that the price of the underlying stock for a call with a ten percent premium rises from a \$100 striking price to \$150. The stock trader buying at \$100 and selling at \$150 would realize a profit of \$50, or fifty percent (excluding commissions¹⁵). The call buyer, however, buying the option for \$10, executing it when the underlying stock reached \$150, and subsequently selling the stock at \$150, would realize a profit of \$40, or four hundred percent. Thus, the options buyer commits much less capital than the purchaser of common stock, and yet gains the opportunity for comparable profits. Investor interest stems chiefly from these leverage benefits of options trading.

Unfortunately, leverage works two ways; the options buyer may lose his entire investment if he cannot exercise his option profitably. Had the stock in the above example declined from \$100 to \$50, the call buyer would have lost his \$10 investment; he would surely have chosen not to exercise the call, because so doing would have compounded the loss. A stock trader, on the other hand, retains the stock and the hope that someday its price will rise enough at least to cover his investment.

In contrast, the options seller, or "writer," often a wealthy individual, seeks to capitalize on these purchasing risks by selling options that the buyer will not likely exercise. Options writing mitigates the writer's risk of loss from downturn in the market price of the underlying stock, because the premium amount is guaranteed as a minimum return. In a declining market the amount of the premium reduces the writer's paper loss; in a rising market the writer's gain is limited to

15. Commissions on options trading approximate those involved in trading other securities. For a trade involving \$100 to \$799 the options commission would be 1.3% plus \$12 whereas the minimum stock commission on 100-share orders would be 2.0% plus \$6.40; for a trade involving \$800 to \$2499 the options commission is 1.3% plus \$12 whereas the stock commission is 1.5% plus \$15; and for a trade involving \$2500 to \$4777 the options commission and the stock commission are both 0.9% plus \$22. Compare Chicago Board Option Exchange Clearing Corporation, Prospectus, at 28 (April 26, 1974) [hereinafter cited as Prospectus], with 29 STANDARD & POOR'S CORP., SECURITY OWNER'S STOCK GUIDE, April 1975, at 254.

the premium amount.¹⁶ Generally, options writers reap greater profits than options buyers,¹⁷ in that writers realize a return regardless of stock fluctuations.¹⁸

Prior to the organization of the CBOE, investors traded options in complicated and awkward fashion via the over-the-counter market.¹⁹ Lacking a central exchange, brokers advertised by newspaper and word of mouth.²⁰ In search of the lowest premium, the customer's broker canvassed various options dealers, thereby increasing the overhead cost.²¹ Poor communication also meant that in almost every case the writer wrote each option contract anew,²² with little attention paid to previous options' valuations. Options prices lacked uniformity, and few, if any, were interchangeable; the climate was wholly unsuitable for the survival of a secondary market. The options buyer could profit only by exercising the option and compelling the writer to fulfill the contract by relinquishing his interest in the stock.

Through its subsidiary, the Chicago Board Options Exchange Clearing Corporation (CBOECC), the CBOE now intervenes between writer and buyer, issuing the options itself. The writer thus contracts directly with the CBOECC,²³ whereas the buyer, instead of looking to the writer for performance, looks to the exchange subsidiary as the options issuer. The CBOE has also eliminated the overhead cost and nonliquidity problems of the traditional options market by standardizing contracts,²⁴ making them freely interchangeable, so as to facilitate the

16. Snyder, *Puts and Calls*, COM. & FINANCIAL CHRONICLE, May 8, 1969, § 2, at 43.

17. *Chicago Board Options: Under Water?*, 112 FORBES, July 15, 1973, at 66; see C. ROSENBERG, STOCK MARKET PRIMER 118 (1974).

18. See Gates, *supra* note 2, at 422.

19. *Id.* at 426-32; see Anderson, *Chicago Options*, 27 BUS. LAW. 7, 9 (1971).

The options markets cannot yet trade puts and can only trade calls for a limited selection of underlying stocks. SEC Securities Exchange Act Release No. 9985 (Feb. 1, 1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,212, at 82,670 (CBOE); SEC Securities Exchange Act Release No. 11,144 (Dec. 19, 1974), [Current Binder] CCH FED. SEC. L. REP. ¶ 80,034, at 84,800 (1974) (American); Wall St. J., March 21, 1975, at 4, col. 2 (PBW). Investors therefore still trade numerous calls and all puts over the counter.

20. Berton, *supra* note 1, at 26.

21. Anderson, *supra* note 19, at 9.

22. See Gates, *supra* note 2, at 427.

23. Prospectus, *supra* note 15, at 22.

24. The CBOE has standardized options by requiring that the option periods, the longest of which may be nine months, must uniformly end on the last day of April, July, October, or January. Over-the-counter options carry comparable restrictions; however, these periods may end on any date upon which the writer and buyer agree. In addition, the striking price must be a multiple of \$5 for an underlying stock valued at under \$50;

establishment of a secondary market. The secondary options market has stimulated enormous interest, because purchasers may now realize profits without paying the stock's option price. Furthermore, they pay substantially lower brokerage commission fees on the premium amount, rather than on the purchase-sale of the stock itself.²⁵ As a further secondary market advantage, the writer may withdraw from the market simply by purchasing the same type of options he has written.

Before interest in options trading awakened, government regulation had waned. During the 1920's the option became a manipulators' tool. Options served to ensure a cheap stock supply and spur activity in a single security, usually by circulating rumors designed to increase or decrease the price.²⁶ These practices generated such intense public concern that an early draft of the Securities Exchange Act of 1934 banned options altogether.²⁷ The put and call brokers then organized,²⁸ and replied by emphasizing such options' benefits as writers' guaranteed premium returns. In response, Congress simply prohibited certain nonoptions manipulative devices²⁹ and authorized the SEC to make necessary options rules.³⁰ Prior to the organization of the CBOE, the SEC never exercised that power;³¹ instead it acquiesced in self-

\$10 for one valued between \$50 and \$100; and \$20 for one valued over \$100. Berton, *supra* note 1, at 27. There is usually only one striking price per underlying stock, but if the market price exceeds a multiple, a writer may offer a second option for the same period at a new striking price. *High Leverage in New Option Exchange*, 39 FINANCIAL WORLD, Feb. 28, 1973, at 7. The underlying stock must appear on the New York Stock Exchange with a minimum price of \$10, and must have traded in volume of at least one million shares for each of the two preceding years. The corporation itself must issue a minimum of ten million shares and list 10,000 shareholders. Berton, *supra* note 1.

25. Berton, *supra* note 1, at 26.

26. SENATE COMM. ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 1455, 73d Cong., 2d Sess. 30-55 (1934); SENATE COMM. ON BANKING AND CURRENCY, FEDERAL SECURITIES EXCHANGE ACT OF 1934, S. REP. NO. 792, 73d Cong., 2d Sess. 9, 17 (1934); HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, SECURITIES EXCHANGE BILL OF 1934, H.R. REP. NO. 1383, 73d Cong., 2d Sess. 10-11, 21 (1934).

27. S. 2693, 73d Cong., 2d Sess. § 8(a)(9) (1934), reprinted in 11 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (1973).

28. B. MALKIEL & R. QUANDT, *supra* note 14, at 12.

29. Securities Exchange Act of 1934 § 9(a), 15 U.S.C. § 78i(a) (1970). Prohibited devices included (1) wash sales and matched orders of securities, (2) the illusion of active trading to induce others to trade, (3) the technique of disseminating information that a stock will fluctuate in order to induce a trade, (4) methods of spreading false information, and (5) price fixing by artificial transactions.

30. Securities Exchange Act of 1934 §§ 9(b)-(c), 15 U.S.C. §§ 78i(b)-(c) (1970).

31. In its first two years the SEC held conferences and conducted studies to determine the extent to which it should allow option trading. The Commission investi-

regulation by the Put and Call Brokers and Dealers Association.³²

II. SEC Authority to Regulate Options Exchanges

When the CBOE proposed to register as a national securities exchange, the SEC theorized that the novelty of options trading, its complex problems and its special risks to the investor warranted a departure from usual registration procedures permitting exchanges to initiate their own rules.³³ Certain securities operations under the traditional regulatory scheme had degenerated somewhat,³⁴ and, confronted with a nascent market devoid of entrenched institutions, the Commission may have considered the moment propitious for assuming a more aggressive and definitive role in exchange regulation. Implementing its authority to classify exchanges³⁵ and promulgate protective options exchange rules,³⁶ the SEC adopted rule 9b-1,³⁷ delegating to itself the

gated trading practices, registration of options dealers, reports concerning the granting or acquiring of options, the duration of options, and endorsement of options by exchange members. 2 SEC ANN. REP. 15 (1936); 1 SEC ANN. REP. 16 (1935). The SEC never adopted any rules, however, adjudging its other antimanipulative weapons sufficiently effective, and declining to further hamper legitimate options usages. 3 L. LOSS, SECURITIES REGULATION 1544 (2d ed. 1961). The Commission has conducted studies of options from time to time in conformity with its responsibilities under sections 9(b) and 9(c) of the 1934 Act, the most recent and notable study having been conducted in 1961. 27 SEC ANN. REP. 67 (1961). Because section 9(b) only forbids conduct contrary to SEC rules, the absence of any SEC-promulgated options regulation might preclude a violation of the statute. See *In re Harold T. White*, 3 S.E.C. 466, 535-37 (1938).

32. B. MALKIEL & R. QUANDT, *supra* note 14, at 12. The New York Stock Exchange adopted rules that had been drafted in contemplation of the passage of the Securities Exchange Act: each member who knew about a substantial option trade relating to listed securities had to file a report; no specialist could deal in options based on the underlying stock in which he was registered; no member could deal in options on the floor; and no member could initiate, on the floor, an options deal in which he had an interest. 3 L. LOSS, *supra* note 31, at 1545 & n.49.

33. SEC Securities Exchange Act Release No. 9930 (Jan. 9, 1973), 38 Fed. Reg. 1646 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,171. The new procedure would allow close supervision of the CBOE during its experimental stage. SEC Securities Exchange Act Release No. 10,552 (Dec. 13, 1973), 38 Fed. Reg. 34,665 (1973), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,604. The SEC did not intend to alter other exchanges' self-regulatory schemes, but merely decided that options exchanges required closer regulation. *Id.*

34. The SEC had recently failed to evoke voluntary adoption of an exchange rule requiring that members conduct a large percentage of their business with the public. See SEC Securities Exchange Act Release No. 9950 (Jan. 16, 1973), 38 Fed. Reg. 3902 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,178.

35. Securities Exchange Act of 1934 § 23(a), 15 U.S.C. § 78w(a) (1970).

36. *Id.* §§ 9(b)-(c), 15 U.S.C. §§ 78i(b)-(c).

37. 17 C.F.R. § 240.9b-1 (1974). Rule 9b-1, in relevant part, states:

(a) It shall be unlawful for a national securities exchange . . . to effect any transactions in an option . . . except in accordance with a plan . . . that is declared effective by the Commission . . .

(1) Before an exchange . . . may effect any transaction in options . . . the

power to initiate an options exchange's regulations. Rule 9b-1 prohibits a national exchange from trading in options without prior submission of a plan to the SEC so that interested parties can respond. The Commission may then require the exchange to "alter, amend, supplement, or rescind" the submission.³⁸ The plan must include the exchange's "regulations, rules, by-laws, constitutional provisions and other requirements" concerning options,³⁹ and must also detail methods for clearing transactions, regulating members who trade for their own account, endorsing options, reporting transactions, and listing trading privileges.⁴⁰ The 9b-1 requirement raises three questions: whether investors need the protection the SEC seeks to provide through the rule; whether the rule will prove effective in regulating options exchanges; and whether the SEC had the authority to enact rule 9b-1.

Investors do require the protection the SEC seeks to provide by rule 9b-1. The threat to investors that necessitated section 9 of the

exchange shall propose and file with the Commission a plan regulating transactions in options on the exchange. . . .

(2) The Commission shall give prompt notice of any proposal filed by an exchange to alter, amend, supplement, or rescind a plan in effect . . . and the proposed change shall become effective upon the 30th day after notice has been given by the Commission . . . unless the Commission shall disapprove the change

(3) . . . [T]he Commission may require that an exchange alter, amend, supplement, or rescind its plan . . . to the extent that the Commission finds to be necessary or appropriate in the public interest or for the protection of investors.

(4) The Commission may take action under any provision of this paragraph (a) without notice and opportunity for interested persons to submit written data, views or arguments . . . for good cause

(b) Plans . . . shall contain . . . the regulations, rules, by-laws, constitutional provisions and other requirements of the exchange that relate solely . . . to transactions in options on the exchange, and shall include provisions relating to—

(1) effecting transactions in options on the exchange by members thereof for their own account and the accounts of customers;

(2) the clearance or settlement of transactions in options;

(3) the endorsement and guarantee of performance of options;

(4) the reporting of transactions in options; and

(5) the listing and delisting of, and the admission to and removal of trading privileges on the exchange for, options. . . .

The rule became effective on January 17, 1974. 39 Fed. Reg. 1261 (1974). The original proposal would have only indirectly regulated exchange rules by forbidding members to trade on noncomplying exchanges. SEC Securities Exchange Act Release No. 10,397 (Sept. 21, 1973), 38 Fed. Reg. 26,943 (1973), [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,517.

38. 17 C.F.R. § 240.9b-1(a)(3) (1974).

39. *Id.* § 240.9b-1(b).

40. *Id.*

Securities Exchange Act,⁴¹ coupled with recent failures in self-regulation procedures,⁴² urge the imposition of permanent safeguards. Moreover, options trading has captivated a virtual throng of neophytes, intent upon plotting a nickle-and-dime course to glorious fortune.⁴³ Absent SEC intervention, these novices could suffer financial devastation at the hands of unscrupulous dealers; furthermore the price instability resulting from widespread, careless investment could injure legitimate investors' interests.⁴⁴

The SEC presently protects investors in traditional equity securities by allowing exchanges voluntarily to adopt rules consistent with the Exchange Act.⁴⁵ Although the exchanges independently self-regulate in lieu of SEC review,⁴⁶ the Commission can revoke an exchange's registration upon violation of the Act or a regulation.⁴⁷ Moreover, the Commission may alter or supplement exchange rules only on specified statutory grounds and only if the exchange fails to comply with an SEC request.⁴⁸ The SEC also requires the reporting of any rule changes, but, because a failure to report does not affect the validity of any exchange rule,⁴⁹ the requirement is virtually impotent. In the past the Commission has refrained from actively tampering with particular rules of exchanges that typically complied voluntarily with SEC sugges-

41. See materials cited note 29 *supra*.

42. See SEC Securities Exchange Act Release No. 9950 (Jan. 16, 1973), 38 Fed. Reg. 3902 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,178.

43. Maidenberg, "Calls" Get Big Play on Exchange in Chicago, N.Y. Times, Sept. 2, 1973, § III, at 13, col. 1 (unsophisticated investors have been attracted to options trading); see N.Y. Times, Feb. 2, 1974, at 34, col. 2 (SEC Commissioner stated gambling is motive of options traders); see also Wall St. J., May 23, 1975, at 1, col. 6 (return of small investors to options market after bear market). But see N.Y. Times, Feb. 14, 1975, at 51, col. 2 (CBOE study indicating that investors in options are highly sophisticated group). Such conflicting characterizations of the options market may result from the different perspectives from which the various observers view regulation.

44. See SEC Securities Exchange Act Release No. 9930 (Jan. 9, 1973), 38 Fed. Reg. 1646 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,171.

45. Securities Exchange Act of 1934 § 6(c), 15 U.S.C. § 78f(c) (1970).

46. See 2 L. Loss, *supra* note 31, at 1171-73.

47. Securities Exchange Act of 1934 § 19(a)(1), 15 U.S.C. § 78s(a)(1) (1970).

48. *Id.* § 19(b), 15 U.S.C. § 78s(b). The specified grounds include (1) safeguards with respect to exchange members' financial responsibility, (2) limitation of the trading of stock for a certain period after issuance, (3) listing of stocks, (4) hours of trading, (5) solicitation of business, (6) fictitious accounts, (7) settlement of accounts, (8) reporting transactions of the exchange, (9) fixing reasonable rates, (10) minimum units of trading, (11) odd-lot trades, (12) margin accounts, and (13) similar matters. See e.g., SEC Securities Exchange Act Release No. 9930 (Jan. 9, 1973), 38 Fed. Reg. 1646 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,171.

49. 17 C.F.R. § 240.17a-8 (1974).

tions.⁵⁰ More recently, however, the Commission has proposed increasingly radical innovations, such as the "institutional membership" rule⁵¹ and fully negotiated commissions,⁵² and has either failed to obtain voluntary compliance,⁵³ encountered widespread industry resistance,⁵⁴ or stumbled over formalistic delay tactics.⁵⁵

In this context, the SEC's decision to formulate new rulemaking procedures for options exchanges was necessary and sensible. Under the auspices of the Administrative Procedure Act,⁵⁶ the SEC empowered itself to amend exchange rules rapidly.⁵⁷ Given the novelty of options and their unknown effect on the securities market, the SEC must utilize that power, often to the point of subitaneous intervention in exchange affairs, so as to counter the pedestrian pace of self-regulation, preserve the status quo of market constancy, and expedite the evaluation of experimental results. Furthermore, lessons gleaned from initiating options trading rules will assist the Commission in devising an alternative to the cumbersome voluntary rulemaking procedures currently governing traditional exchanges.

In response to the second question—whether rule 9b-1 will, in fact, prove effective—the SEC may have failed to reserve the authority necessary to regulate options exchanges properly.⁵⁸ Rule 9b-1(a)(3) applies only to an exchange's initial plan: the language merely prohibits options trading before SEC approval of the plan.⁵⁹ Apparently,

50. Cf. SEC Securities Exchange Act Release No. 9950 (Jan. 16, 1973), 38 Fed. Reg. 3902 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,178.

51. See *PBW Stock Exch., Inc. v. SEC*, 485 F.2d 718, 734 n.3 (3d Cir. 1973), cert. denied, 416 U.S. 969 (1974).

52. Address by Ray Garrett, Chairman of the SEC, ABA 56th Nat'l Trust Conference, Miami Beach, Florida, Jan. 28, 1975, [Current Binder] CCH FED. SEC. L. REP. ¶ 80,085 (1975).

53. See SEC Securities Exchange Act Release No. 9950 (Jan. 16, 1973), 38 Fed. Reg. 3902 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,178.

54. Cf. N.Y. Times, Jan. 23, 1975, at 47, col. 4.

55. See SEC Securities Exchange Act Release No. 10,552 (Dec. 13, 1973), 38 Fed. Reg. 34,665 (1973), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,604.

56. 5 U.S.C. § 553(c) (1970).

57. 17 C.F.R. § 240.9b-1(a)(4) (1974).

58. Effective rulemaking also includes the capability of designing rules that work. This would include whether the SEC possesses sufficient manpower to carry out the necessary investigations; however, the SEC currently relies upon a review of options exchanges' plans for the needed information.

59. Compare 17 C.F.R. § 240.9b-1(a)(2) ("rescind a plan in effect"), with *id.* § 240.9b-1(a)(3) ("rescind its plan"). The absence of the phrase "in effect" in rule 9b-1(a)(3) indicates that the exchange rulemaking power of the Commission applies only to a plan not yet in effect. Rule 9b-1(a)(2) does allow the Commission to regulate an exchange's alteration of its own options rules.

stock exchanges may still adopt rules consistent with the Securities Exchange Act in the wake of the Commission's declared intent not to supplant the self-regulatory exchange functions.⁶⁰ By the terms of rule 9b-1(a)(2), however, the SEC may supervise any modifications made by the exchange after the Commission's approval of the initial plan. Yet the language arguably authorizes subsequent supervision by the SEC only in the face of affirmative, amendatory action by the exchange, thereby suggesting that the Commission would be powerless to intervene spontaneously and enforce modifications in the exchange's experimental plan. Clearly, however, the SEC interprets the rule differently and envisions a more active supervisory role.⁶¹ To preclude an unfavorable judicial interpretation, the SEC could simply amend the rule, molding the language to a precise articulation of the Commission's intent.

Yet the question remains whether the SEC has authority to promulgate such a rule. Even with a clearer rule, the SEC must answer the contention that section 19 of the Exchange Act,⁶² which delineates SEC powers over exchanges and securities, overrides and restricts the Commission's power to alter an established exchange's rules.⁶³ Under section 19, the SEC formerly claimed the authority to promulgate exchange rules when deemed necessary for the protection of investors.⁶⁴ Ensuing litigation failed to resolve the authority issue and failed also to establish a test for the validity of the investor-protection claim. The SEC had wielded rule 19b-2⁶⁵ as its vehicle for requiring that all regulated exchanges adopt rules conditioning exchange membership on willingness to serve the public.⁶⁶ In *PBW Stock Exchange, Inc. v.*

60. SEC Securities Exchange Act Release No. 10,552 (Dec. 13, 1973), 38 Fed. Reg. 34,665 (1973), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,604.

61. The SEC shall have the "opportunity to comment upon all proposed plans and proposed changes in effective plans." *Id.* The SEC "... may by order require the adoption, amendment, alteration, or rescission of any rule of a national securities exchange. . . ." SEC Securities Exchange Act Release No. 9930 (Jan. 9, 1973), 38 Fed. Reg. 1646 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,171. Speculation as to the efficacy of the rule as envisioned by the SEC is only tentative at this time and does not obviate the need to compare the literal wording with the Commission's apparent intentions.

62. 15 U.S.C. § 78s(a)-(b) (1970).

63. *Cf. PBW Stock Exch., Inc. v. SEC*, 485 F.2d 718 (3d Cir. 1973), *cert. denied*, 416 U.S. 969 (1974).

64. *Id.*

65. 17 C.F.R. § 240.19b-2 (1974).

66. The rule dictates that a member must conduct eighty percent of his transactions with the public. *Id.*

SEC,⁶⁷ plaintiff exchange attacked rule 19b-2, contending that Congress, in passing the Securities Exchange Act, denied the Commission rulemaking power by deleting the authorization⁶⁸ from the bill's final version.⁶⁹ The PBW Stock Exchange further argued that the SEC had no power to alter or supplement an established exchange's rules, except as provided in section 19, which purports to safeguard investors rather than brokers.⁷⁰ The Commission responded⁷¹ by quoting section 23(a) of the Act, which states that the SEC may "make such rules and regulations as may be necessary for the execution of the functions" authorized by the Act.⁷² Although the Supreme Court has held that comparable clauses in other acts grant broad powers,⁷³ the *PBW* court never resolved whether the SEC can supplement an exchange's rules, inasmuch as it dismissed the petition on jurisdictional grounds.⁷⁴ Thus, the third question—whether under section 19 the SEC had the authority to enact rule 9b-1—remains unsettled, and, because it invades a province once reserved to exchange members, the authority issue may spur further litigation.

Rule 9b-1 will likely not fall to a *PBW*-type attack for several reasons. First, the SEC has yet to establish a fully nonexperimental options exchange;⁷⁵ thus, there are no powerful institutions intent upon protecting their income sources through litigation, as in *PBW*.⁷⁶ Second, the rule purposes to protect investors, a goal that conforms with the general aims of the Exchange Act; rule 19b-2, however, was

67. 485 F.2d 718 (3d Cir. 1973), *cert. denied*, 416 U.S. 969 (1974), *noted in* 52 TEXAS L. REV. 1014 (1974).

68. H.R. 7852, 73d Cong., 2d Sess. § 18(c) (1934).

69. Brief for Petitioner at 24-26, *PBW Stock Exch., Inc. v. SEC*, 485 F.2d 718 (3d Cir. 1973). In so arguing, petitioner attempted to frame rule 19b-2 as merely an administrative order.

70. *Id.* at 20-21, 28-33. See Securities Exchange Act of 1934 § 19, 15 U.S.C. § 78n (1970). Rule 19b-2 protects brokers by providing increased commission from institutional investors who must now trade as members of the public.

71. Brief for Respondent at 34, *PBW Stock Exch., Inc. v. SEC*, 485 F.2d 718 (3d Cir. 1973).

72. Securities Exchange Act of 1934 § 23(a), 15 U.S.C. § 78w(a) (1970).

73. *American Trucking Ass'ns v. United States*, 344 U.S. 298, 311-12 (1953); *accord*, *Thorpe v. Housing Authority*, 393 U.S. 268, 280-81 (1969); *United States v. Southwestern Cable Co.*, 392 U.S. 157, 177-78 (1968); *Permian Basin Area Rate Cases*, 390 U.S. 747, 787 (1968).

74. *PBW Stock Exch., Inc. v. SEC*, 485 F.2d 718 (3d Cir. 1973), *cert. denied*, 416 U.S. 969 (1974). The court abstained from reviewing the merits of the case because a "regulation" rather than an "order" was involved.

75. SEC Securities Exchange Act Release No. 9985 (Feb. 1, 1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,212, at 82,670.

76. Options trading has gained in attractiveness, however, and a number of these institutions appear eager to enter the field. *Option Plays Are Spreading*, *supra* note 5, at 106.

designed to aid brokers. Third, the SEC will likely exercise the power only in important actions, in light of the present staff's reluctance about policing several options exchanges as opposed to one central exchange.⁷⁷ Fourth, unlike section 19, which grants limited rulemaking power,⁷⁸ section 9(b) authorizes the SEC to formulate *any* options-related rule necessary to protect investors. The Commission, however, would likely prefer to sustain its affirmative rulemaking role on a basis broader than section 9(b): only section 19's general provision will support extension of the aggressive approach beyond options, to stock exchanges generally.

III. SEC Information Requirements

One of the SEC's primary objectives is to ensure that investors have suitable access to risk and financial information, so that they may make knowledgeable, rational decisions whether to invest in the highly risky undertaking of options trading. To achieve this end the SEC possesses two methods—requiring registration of options under the Securities Act,⁷⁹ and regulating options trading under the Securities Exchange Act.⁸⁰

A. *Present Options Information Requirements*

Current SEC rules temporarily permit the utilization of an information system for options similar to that used for other types of securities trading, *i.e.*, registration of the securities, presentation of a prospectus, and delivery of the certificate.⁸¹ Options registration poses two questions: does the SEC possess the authority to require such registration, and, if so, what should be the nature and extent of disclosure required?

The SEC probably does possess the authority to require options registration. Before the CBOE begat the options craze, the SEC had never required registration of puts and calls, because it did not recognize puts and calls as "securities" under the Securities Act.⁸² The se-

77. *Id.*

78. The SEC has not abandoned the idea that section 19 of the Securities Exchange Act grants exchange rulemaking power similar to that of section 9. SEC Securities Exchange Act Release No. 9930 (Jan. 9, 1973), 38 Fed. Reg. 1646 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,171.

79. Securities Act of 1933 § 5(b)(2), 15 U.S.C. § 77e(b)(2) (1970).

80. Securities Exchange Act of 1934 § 9(b), 15 U.S.C. § 78i(b) (1970).

81. Securities Act of 1933 § 5(b)(2), 15 U.S.C. § 77e(b)(2) (1970).

82. Anderson, *supra* note 19, at 13.

curities acts include within their definition of a security a "right to subscribe to or purchase a security,"⁸³ a definition that should encompass the call,⁸⁴ and the SEC now requires their registration.⁸⁵ A more difficult question is the SEC's authority to regulate puts. Recently the SEC has indicated that it intends to treat puts as securities also. In defining the expression, "equity securities," in rule 3a11-1,⁸⁶ the SEC included puts for "the purpose of clarity."⁸⁷ One federal court, in holding that a put does qualify as a security, seized upon the rule's language, to facilitate the finding of a fraud violation.⁸⁸ Little opposition to the inclusion of options within the security definition has evolved, because even if the term "security" does not include options, the SEC can still require options registration by formulating a rule under section 9(b) of the Securities Exchange Act, which authorizes the Commission to make whatever options rules it deems appropriate to the public interest.⁸⁹

Options registration poses a fundamental problem: should detailed disclosures be required, and to what extent? The SEC has not provided options registration forms, nor has it acted to enforce registration.⁹⁰ The Commission has also yet to determine what information the issuer should include in the registration, although its approval of

83. Securities Act of 1933 § 2(1), 15 U.S.C. § 77(b)(1) (1970); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970). The "security" definition was intended to be the same in the Securities Act and the Securities Exchange Act. *See* SENATE COMM. ON BANKING AND CURRENCY, FEDERAL SECURITIES EXCHANGE ACT OF 1934, S. REP. NO. 792, 73d Cong., 2d Sess. 14 (1934). *But see* 1 L. LOSS, *supra* note 31, at 479.

84. *See* SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 292 (S.D.N.Y. 1966), *aff'd in part, rev'd in part*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (stock option is a security).

85. Dean Witter & Co., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,602. A registered broker desired to assist in call option writing without registering and requested a no-action position from the SEC. The Commission determined that, absent an exemption, call options could not be sold to the public without registration, but it did not pass on the nature or extent of disclosure necessary. *Id.* *See generally* 1 L. LOSS, *supra* note 31, at 469.

86. 17 C.F.R. § 240.3a11-1 (1974).

87. SEC Securities Exchange Act Release No. 9929 (Jan. 29, 1973), 38 Fed. Reg. 11,449 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,196.

88. Vogel-Lorber, Inc. v. Options on Shares, Inc., [Current Binder] CCH FED. SEC. L. REP. ¶ 94,911 (S.D.N.Y. 1974).

89. 15 U.S.C. § 78i(b) (1970).

90. SEC Securities Act Release No. 5444 (Dec. 13, 1973), 39 Fed. Reg. 1283 (1974), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,602. The Commission has, however, encouraged inquiries into what kinds of disclosures would best serve registration of puts and calls on current forms. *See* Dean Witter & Co., *supra* note 85. *See also* Gates, *supra* note 2, at 438.

the CBOECC prospectus offers an indication of the SEC's posture. The CBOECC, which issues and endorses⁹¹ CBOE options, devotes most of its prospectus to risk and financial data concerning options trading in general, referring only vaguely to information about the underlying stock.⁹² Several reasons explain the SEC's acquiescence in not specifying the information desired. Although the buyer has a special interest in the underlying stock, especially its price volatility, the issuer of the option may not be in a practical position to supply such information. As an outsider, the issuer has ready access only to published sources, the accuracy of which could not be verified.⁹³ Moreover, price volatility information becomes crucial to the purchaser when he deals in "down-side-out" calls and "upside-down" puts.⁹⁴ In those cases, the SEC suggests disclosure of market fluctuations over appropriate time periods.⁹⁵ Finally, the option writer should not have to perform the buyer's research and market assessments for him.⁹⁶

B. Proposed Options Information Requirements

Increased options activity and its incidental risks have prompted the SEC to propose rule 9b-2,⁹⁷ which mandates more effective dis-

91. An endorser obligates himself to the buyer to deliver the underlying stock upon exercise of the call.

92. *Id.* at 13-14.

93. Gates, *supra* note 2, at 438-39. This information would be readily obtainable if the underlying stock were registered. See Prospectus, *supra* note 15, at 13.

94. Gates, *supra* note 2 at 439. These expiration price options involve a special risk that makes price volatility a major concern in triggering expiration. For regular options, however, the purchaser will gain as long as he exercises the option at a profitable point.

95. *In re* Goldman, Sachs & Co., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,159.

96. The Commission properly recognizes, however, that the option purchaser should be furnished information about writers' and endorser's financial status.

97. Proposed SEC Reg. § 240.9b-2, 38 Fed. Reg. 35,334 (1973), 2 CCH FED. SEC. L. REP. ¶ 22,623 (1974). Rule 9b-2, in relevant part, states:

(a) *Option Disclosure.* It shall be unlawful for any broker . . . to effect . . . the purchase or sale of any option unless, at least 48 hours prior to execution of such purchase or sale, the broker . . . has delivered or caused to be delivered to the customer (A) a written statement which prominently includes material setting forth the nature and extent of the obligations under, as well as the risks attendant to, the purchase or sale of such options generally, or (B) a prospectus . . . , and unless the broker . . . delivers thereafter any supplemental written statement necessary to make current the disclosures . . . before effecting any purchase or sale

(b) *Option Suitability.* No broker . . . shall recommend to any customer—

(1) any transaction in an option unless the broker . . . has reasonable grounds to believe that the entire recommended transaction is not unsuitable . . . or

(2) the purchase of a [limited price option] . . . unless, in addition to complying with the requirements of subparagraph (b)(1), the broker . . . obtains

Options Regulation

closure, specific suitability standards, and, with respect to endorser, accurate reporting and minimum net capital levels.⁹⁸ In addition, the Commission has proposed rule 238, which permits exemption from options registration if the security offered meets certain well-delineated conditions.⁹⁹ The proposals effectuate the Commission's intent to construct more restrictive guidelines for investor protection as well as market efficiency.¹⁰⁰ In a trading scheme fraught with high potential risks for unwary investors, the new standards respond to the two main criticisms usually leveled at the current registration method—that disclosure often reaches the investor after he has already committed to purchase,¹⁰¹ and that he often does not understand the complexities of disclosures.¹⁰²

1. *Disclosure.*—Proposed rule 9b-2(a) would expand brokers'

. . . from the customer such information . . . as to have reasonable grounds to believe . . . that the customer understands the special characteristics of such option.

(c) *Uncovered Calls and Offsetting Puts.* No broker . . . shall effect . . . any transaction whereby such customer writes [an uncovered option] . . . or [an offsetting put] . . . unless, on the basis of information obtained by such broker, . . . after reasonable inquiry, . . . he has a reasonable basis for believing that the customer . . . is capable of evaluating the additional risks in such transactions, and has the financial capability to meet reasonably foreseeable margin calls

(d) *Reporting Requirement.*

(1) It shall be unlawful for any broker or dealer to endorse an option unless such broker or dealer files reports

(2) Individual reports filed by . . . brokers . . . shall be considered nonpublic information

(3) This paragraph (d) shall not apply to any option registered on a national securities exchange.

(e) *Net Capital Requirement.* It shall be unlawful for any broker . . . to endorse . . . an option unless such broker . . . has net capital . . . of not less than \$50,000

98. SEC Securities Exchange Act Release No. 9994 (Feb. 8, 1973), 38 Fed. Reg. 4994 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,221.

99. SEC Securities Act Release No. 5444 (Dec. 13, 1973), 39 Fed. Reg. 1283 (1974), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,602; SEC Securities Act Release No. 5366 (Feb. 8, 1973), 38 Fed. Reg. 4993 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,222. The statutory basis for proposed rule 238 is Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (1970).

100. The SEC has taken a similarly protective position with regard to another securities field involving high risks for investors. See SEC Securities Exchange Act Release No. 11,125 (Dec. 9, 1974), 39 Fed. Reg. 44,520 (1974), [Current Binder] CCH FED. SEC. L. REP. ¶ 80,023 (warning to unscrupulous promoters and fraudulent schemes in the opening of the gold market); SEC Securities Exchange Act Release No. 11,158 (Dec. 31, 1974), 40 Fed. Reg. 1520 (1975), [Current Binder] CCH FED. SEC. L. REP. ¶ 80,039 (proposed rule 15c3-5 regulating the broker-customer relationship in gold trading).

101. See Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 BUS. LAW. 300, 301-03 n.6 (1961).

102. See Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROB. 193, 209-12 (1958).

disclosure responsibilities by requiring that they furnish the customer, not later than forty-eight hours prior to the initial transaction, a written statement explaining the nature and extent of the customer's obligation and the risks involved in options trading. Previously, the Commission required brokers to disclose risk information about the companies they *recommended* for investment only when their own lack of essential information about the company engendered the risk.¹⁰³ Recommendations about investment stocks conceivably brought to the broker-customer relationship a special intimacy¹⁰⁴ that deserved the careful scrutiny denied to options trading. The SEC also required that the prospectuses of new issues registered under the Securities Act disclose the risks implicit in speculative offerings.¹⁰⁵ Options that are not traded on an exchange resemble new issues in that both are traded on a primary market. The broker, who usually does not write options, instead assumes the role of underwriter. Because the option resembles a new issue, and the broker serves as its underwriter,¹⁰⁶ options investors should, logically, acquire information similar to that available in a new issue's prospectus. In the case of options traded on an exchange, the broker would satisfy proposed rule 9b-2(a) by supplying the client with the option issuer's prospectus (*e.g.*, the prospectus of the CBOECC) before the forty-eight hour period.¹⁰⁷

Proposed rule 9b-2(a) would, however, impose stricter standards than does the present rule for new offerings. The Securities Act requires that the prospectus only accompany or precede delivery of the security;¹⁰⁸ the requirement has lost all utility to situations in which the buyer, relying on a broker's oral representations, commits himself to a purchase before seeing the prospectus.¹⁰⁹ For disclosure to provide customers with the opportunity to make informed investment deci-

103. See *SEC v. North American Research & Dev. Corp.*, 424 F.2d 63, 84 (2d Cir. 1970); *Hanly v. SEC*, 415 F.2d 589, 596-97 (2d Cir. 1969).

104. See cases cited note 103 *supra*.

105. SEC Securities Act Release No. 4936 (Dec. 9, 1968), 33 Fed. Reg. 18,617 (1968), [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,636; see Securities Act of 1933 § 10, 15 U.S.C. § 77j (1970). See also *Doman Helicopters, Inc.*, 41 S.E.C. 431, 439 & n.16 (1963).

106. Underwriters are liable for failing to disclose required information for new issues. Securities Act of 1933 §§ 2(11), 5, 15 U.S.C. §§ 77b(11), 77e (1970).

107. Proposed SEC Reg. § 240.9b-2(a), 38 Fed. Reg. 35,334 (1973), 2 CCH FED. SEC. L. REP. ¶ 22,623 (1974).

108. Securities Act of 1933 § 5b(2), 15 U.S.C. § 77e(b)(2) (1970).

109. Jennings, *supra* note 102, at 210. Apparently, this mode of transaction represents the rule rather than the exception. See Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L. REV. 311, 325 n.71 (1974).

sions,¹¹⁰ there must be adequate time for deliberation; accordingly, some commentators have favored requiring disclosure at least forty-eight hours prior to purchase.¹¹¹ The SEC has not demanded prepurchase disclosure for transactions involving new stock issues,¹¹² but the complexities of options markets and the potential for abuse will likely move the Commission to adopt such a requirement for the options trading scheme.¹¹³ Furthermore, the classic arguments against prepurchase disclosure lose force when applied to options trading. First, the disclosure requirement would not always hamper options trade spontaneity,¹¹⁴ because proposed rule 9b-2(a) applies only to the customer's initial transaction. If the broker anticipates timed trading,¹¹⁵ he may furnish blanket disclosures for all or some of his clientele; the disclosure requirement would then impede timed trading only when new customers enter the market. Second, the cost should not be prohibitive,¹¹⁶ because the broker need only provide one full disclosure to each customer, and subsequent sales would merely necessitate an updating of information.¹¹⁷

The effectiveness of proposed rule 9b-2(a) will depend upon the solution of several potential problems. To avoid delays in timed sales and simultaneously to reduce disclosure costs, the broker might provide only one explanatory prospectus, notwithstanding proposed rule 9b-2(a)(B),¹¹⁸ which arguably requires a prospectus for *each* exchange licensed to issue options—at present, two (one for the CBOE and one

110. See *In re Tucker Corp.*, 26 S.E.C. 249 (1947); Anderson, *supra* note 109, at 312 & n.4.

111. See, e.g., Pringle, *Summary Prospectus Proposal of Midwest Securities Commissioners Association*, 23 BUS. LAW. 567, 569 (1968).

112. See 17 C.F.R. § 230.434a (1974); SEC Securities Act Release No. 4968 (April 24, 1969), 34 Fed. Reg. 7235 (1969), [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,685 (preliminary prospectus received forty-eight hours before the mailing of the confirmation of sales); cf. 17 C.F.R. § 230.256 (1974); SEC Securities Act Release No. 5397 (June 1, 1973), [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,385 (stock-offering circulars governed by a forty-eight-hour requirement).

113. See SEC Securities Exchange Act Release No. 9994 (Feb. 8, 1973), 38 Fed. Reg. 4994 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,221.

114. See SEC Securities Exchange Act Release No. 10,550 (Dec. 13, 1973), 38 Fed. Reg. 35,334 (1973), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,601; Pringle, *supra* note 111, at 568.

115. In timed sales the investor's profit depends upon the broker's executing the order at the proper time. Such an investor might lose a portion of that hoped-for profit on his initial trade if he must wait forty-eight hours before the broker may execute his order.

116. Pringle, *supra* note 111, at 568.

117. Proposed SEC Reg. § 240.9b-2(a), 38 Fed. Reg. 35,334 (1973), 2 CCH FED. SEC. L. REP. ¶ 22,623 (1974).

118. *Id.* § 240.9b-2(a)(B).

for the American Stock Exchange) and, foreseeably, several others. Alternatively, brokers may disclose information on "the purchase . . . of such options generally,"¹¹⁹ which suggests that one prospectus would suffice, an interpretation more desirable in light of both delay and cost objections. Furthermore, the complexity and potential abuse of options trading actually necessitates disclosure, not the fiscal strength of the exchange's clearing corporation. The prospectus of any one exchange, therefore, should apprise the customer of the nature and risks of options trading, and the broker should supply needed financial data about the exchange's clearing corporation in the conventional manner, upon delivery of the securities.¹²⁰

The proposed rule also permits the broker to deliver supplemental material after the beginning of the forty-eight-hour period and before the purchase.¹²¹ Apparently, nothing prevents him from furnishing an essentially useless statement, followed, at the time of purchase, by a more informative supplement—a procedure that would deny the customer an adequate inspection and would, in effect, render the proposed rule self-defeating.¹²² To sidestep this loophole requires interpreting "supplemental written statement" to include all information acquired by the broker after delivery of the initial disclosure statement, necessarily excluding any information already known to the broker at the time of the initial delivery. Still, the proposed 9b-2(a) requires only that the broker have "delivered or caused to be delivered to the customer" the disclosure statement in advance of the forty-eight-hour period.¹²³ Conceivably, the broker might orally explain the risks to the customer, and then mail the statement and execute a sale after waiting forty-eight hours, so that the customer might receive the statement after any usefulness had waned—a result that obviously clashes with the aim of the proposed rule.¹²⁴ The Commission could avoid this hazard by interpreting the delivery phrase to require that the customer actually

119. *Id.* § 240.9b-2(a)(A).

120. The CBOE's informative prospectus will probably serve as the model for other exchanges' prospectuses. 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 2.21[6], at 2-58.10 (1975).

121. Proposed SEC Reg. § 240.9b-2(a), 38 Fed. Reg. 35,334 (1973), 2 CCH Fed. Sec. L. Rep. ¶ 22,623 (1974).

122. See SEC Securities Exchange Act Release No. 10,550 (Dec. 13, 1973), 38 Fed. Reg. 35,334 (1973), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,601.

123. Proposed SEC Reg. § 240.9b-2(a), 38 Fed. Reg. 35,334 (1973), 2 CCH FED. SEC. L. REP. ¶ 22,623 (1974).

124. See SEC Securities Exchange Act Release No. 10,550 (Dec. 13, 1973), 38 Fed. Reg. 35,334 (1973), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,601.

receive the statement no later than forty-eight hours prior to the purchase.¹²⁵ The proposed disclosure requirement, in its present form, although intended to guarantee customers the prepurchase information necessary for a knowledgeable investment decision, may have no protective effects in the important context of an investor's first transaction.

The proposed rule presents a final problem: the customer may neither read nor understand the statement.¹²⁶ Options trading can attract small investors because options are available for a small percentage of the underlying stock's price. Many of these purchasers may not fully comprehend options complexities. Nevertheless, imposition of disclosure standards on options transactions might prove as ineffectual a remedy as have such standards for new offerings. The effectiveness of the disclosure rule, therefore, will depend on another section of the proposed regulation, its suitability rule,¹²⁷ which purports to assure that the broker will actually impart an understanding of options mechanics to his customer.

2. *Suitability*.—The first SEC suitability rule applicable to all types of securities, rule 15b10-3,¹²⁸ was adopted in 1967.¹²⁹ In 1974 the SEC promulgated an alternative suitability rule, emphasizing the investor's capacity to evaluate a specific investment.¹³⁰ The general suitability rule requires that, before recommending a transaction, the broker must have a reasonable basis to believe, after inquiry, that the transaction will not inordinately drain the client's financial resources.¹³¹ The pro-

125. Rule 256, which requires forty-eight-hour notice of an offering circular, *does* require receipt by the customer before the forty-eight-hour period. 17 C.F.R. § 230.256 (a)(2) (1974). Because the substantially different wording in rule 256 may warrant a different interpretation of proposed rule 9b-2(a), *cf.* *Dickenson v. Fletcher*, L.R. 9 C.P. 1, 7-8 (1873) (change in language of subsequent statute *in pari materia* creates different meaning), the SEC should revise proposed rule 9b-2(a) so that it requires actual receipt of a prospectus by the customer.

126. *See Douglas & Bates, The Federal Securities Act*, 43 YALE L.J. 171, 171-72 (1933).

127. Proposed SEC Reg. § 240.9b-2(b), 38 Fed. Reg. 35,334 (1973), 2 CCH FED. SEC. L. REP. ¶ 22,623 (1974).

128. 17 C.F.R. § 240.15b10-3 (1974).

129. SEC Securities Exchange Act Release No. 8135 (July 27, 1967), 32 Fed. Reg. 11,637 (1967), [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,459.

130. SEC Reg. § 230.146(d), 39 Fed. Reg. 15,261 (1974), 1 CCH FED. SEC. L. REP. ¶ 2710 (1974).

131. Proposed SEC Reg. § 240.9b-2(b)-(c), 38 Fed. Reg. 35,334 (1973), 2 CCH FED. SEC. L. REP. ¶ 22,623 (1974). The suitability rule in other areas of law requires an express representation that the transaction suits the client's needs. *See Anderson v. Knox*, 297 F.2d 702 (9th Cir. 1961), *cert. denied*, 370 U.S. 915 (1962) (sale of insurance). In the securities industry, however, such a representation inheres in the broker-customer relationship. E. WEISS, REGISTRATION AND REGULATION OF BROKERS

posed suitability rule includes two modifications¹³² with respect to two kinds of options—the limited price option, which expires before the term if the price of the underlying stock reaches a certain level, and the uncovered, or “naked,” option, which permits the writer to forego purchasing the underlying stock and exposes both writer and endorser to an unlimited loss. The proposed rule would require that, upon recommending a trade in a limited price option, the broker must have reasonable grounds for believing that the customer *understands* its mechanics.¹³³ The broker dealing in uncovered options must also reasonably conclude that his customer can evaluate the risks *and* bear the loss, regardless of any broker recommendations.¹³⁴

Despite their paternalistic purpose, sections (b) and (c) of proposed rule 9b-2 suffer from the failure to provide standards for determining what constitutes reasonable grounds for belief that the customer either understands or has the capacity to evaluate. The limited-price option requirement, for example, neglects to explain the appropriate test for determining a customer's level of expertise. Neither by merely asking the customer whether he understands the mechanics nor by orally explaining limited options to him can the broker objectively ascertain that the customer does, in fact, comprehend. An oral presentation could also present subsequent evidentiary problems should the customer conveniently fail to remember its salience. On the other hand, a more definite method, such as an oral or written test, might offend the cus-

AND DEALERS 184-85 (1965). The National Association of Securities Dealers, a self-regulatory, private association of brokers organized under section 15 of the Securities Exchange Act of 1934, 15 U.S.C. § 780-3 (1970), has long enforced a suitability requirement based solely upon the personal financial information supplied by the client. *Boren & Co.*, 40 S.E.C. 217, 227 (1960). Some federal courts, however, have refused to enforce the NASD rule, holding, instead, that its violation would not engender federal civil liability, but may, when asserted under a federal court's pendent jurisdiction, constitute evidence in support of a common law claim of negligence or breach of fiduciary duty. *See Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1209 (9th Cir. 1970); *Mercury Investment Co. v. A.G. Edwards & Sons*, 295 F. Supp. 1160, 1163 (S.D. Tex. 1969). *See also Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 700-01, 69 Cal. Rptr. 222, 232-33 (Ct. App. 1968).

132. Compare Proposed SEC Reg. § 240.9b-2(b)-(c), 38 Fed. Reg. 35,334 (1973), 2 CCH FED. SEC. L. REP. ¶ 22,623 (1974), with 17 C.F.R. § 240.15b10-3 (1974). There are two minor differences between rule 15b10-3 and proposed rule 9b-2(b): first, by omission of the word “security” rule 9b-2(b) avoids interpreting whether a put qualifies as a security; and second, unlike rule 15b10-3, proposed rule 9b-2(b) applies to all brokers and dealers, not just nonmembers of the National Association of Securities Dealers.

133. Proposed SEC Reg. § 240.9b-2(b), 38 Fed. Reg. 35,334 (1973), 2 CCH FED. SEC. L. REP. ¶ 22,623 (1974).

134. *Id.* § 240.9b-2(c).

Options Regulation

tomers. Rule 146(d),¹³⁵ the suitability standard for private offerings, requires only that the broker determine the customer's ability to evaluate the risk or bear the loss. Accordingly, a nonoptions broker may limit his inquiry to easily verifiable financial records and eschew the subjective considerations. In uncovered options writing, the SEC would require the broker to investigate further into subjective characteristics. Administrative or judicial formulation of a uniform standard for rating investors' comprehension should alleviate many suitability problems for brokers.

3. *Reporting and Capital Requirements.*—The remainder of proposed rule 9b-2 addresses reporting and net capital requirements.¹³⁵ Under proposed rule 9b-2(e), a broker who endorses an option must maintain a net capitalization of \$50,000.¹³⁷ Failure to comply with the net capital requirement would result in suspension¹³⁸ or revocation¹³⁹ of the broker's registration. This provision, although similar to rule 15c3-1,¹⁴⁰ effectively comprehends the special risks of options trading. Proposed rule 9b-2(d)¹⁴¹ would aid in enforcing the net capital requirement by compelling the broker to report weekly the number and kind of options he endorses and report monthly his total number of unexercised options. From the SEC's standpoint, strict adherence to the reporting requirements is essential to the protection of investors;¹⁴² accordingly, falsification of records carries a severe penalty, the revoca-

135. SEC Reg. § 230.146(d), 39 Fed. Reg. 15,261 (1973), 1 CCH FED. SEC. L. REP. ¶ 2710 (1974).

136. Proposed SEC Reg. § 240.9b-2(d)-(e), 38 Fed. Reg. 35,334 (1973), 2 CCH FED. SEC. L. REP. ¶ 22,623 (1974).

137. The \$50,000 capital requirement provides a drawing fund for the option holder should he choose to exercise the option.

138. Cf. SEC Securities Exchange Act Release No. 9416 (Dec. 13, 1971), [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,468 (rule 15c3-1 net capital requirement).

139. See *Blaise D'Antoni & Assoc., Inc. v. SEC*, 289 F.2d 276 (5th Cir.), cert. denied, 368 U.S. 889 (1961).

140. 17 C.F.R. § 240.15c3-1(a)(4) (1974). The rule requires a minimum \$2,500 in net capital, and permits a 2000% indebtedness for brokers and dealers who meet specified conditions. Rule 15c3-1(b)(2) exempts brokers who deal on the six named exchanges that employ a net capital requirement in excess of that contemplated by the rule. The CBOE is one such exchange. SEC Securities Exchange Act Release No. 9988 (Feb. 2, 1973), 38 Fed. Reg. 4315 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,213. The statutory basis for proposed rule 9b-2(e) is the Securities Exchange Act of 1934 §§ 9(b), 15(c)(3), 15 U.S.C. §§ 78i(b), 78o(c)(3) (1970).

141. The statutory basis for proposed rule 9b-2(d) is Securities Exchange Act of 1934 §§ 9(b), 17(a), 15 U.S.C. §§ 78i(b), 78q(a) (1970).

142. SEC Securities Exchange Act Release No. 9468 (Jan. 27, 1972), [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,498.

tion of registration.¹⁴³ A customer may invoke proposed rule 9b-2 as a basis for imposing civil liability upon the broker. Prior decisions¹⁴⁴ held that civil liability could not depend on section 9b, because it only prohibited options transactions conducted "in contravention of such rules and regulations as the Commission may prescribe."¹⁴⁵

4. *Exemptions.*—To relieve somewhat the issuers' burden in options registration, the SEC has considered adopting an exemption that would eliminate options registration and reduce unnecessary costs in those cases involving suitably protected investors. Because most of the registration information elicited by the purchaser deals with the nature of transaction risks and endorser's finances, proposed rule 9b-2, by already requiring these disclosures, offers the ideal justification for an exemption. Proposed rule 238 permits exemption from registering options, other than limited price options,¹⁴⁶ if (1) the issuer of the underlying stock satisfies the reporting requirements;¹⁴⁷ (2) the issuer of the underlying security registers the securities; (3) the options issuer does not also issue the underlying stock; (4) the endorser is a registered dealer; and (5) the gross sales aggregate of all "related options" does not exceed \$500,000. The SEC defines "related options" as an underlying stock's total number of either puts or calls that expire in the same month. Thus, for purposes of proposed rule 238, a put would not be "related" to a call: puts and calls would be considered separately.

Proposed rule 238 promises several effects. The SEC's definition of "issuers" as including both options writers and endorser's would

143. See *In re* Leo G. MacLaughlin Sec. Co., SEC Securities Exchange Act Release No. 7783 (Jan. 5, 1966), [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,317; *In re* Woods & Co., 41 S.E.C. 725 (1963).

144. *Wolfson v. Parkway Management Co.*, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,967, at 96,294 (S.D.N.Y. 1967). Subsequent option traders have failed to establish a 9b cause of action in the absence of relevant rule.

145. 15 U.S.C. § 78i(b) (1970).

146. The original proposed rule 238 also exempted limited price options. SEC Securities Act Release No. 5366 (Feb. 8, 1973), 38 Fed. Reg. 4993 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,222. The SEC considers them so speculative, however, that exemption from the disclosure requirements is not warranted. As a result, limited price options will probably disappear. See Frankhauser, *Options Regulation*, 7 REV. OF SEC. REGULATION 887, 888 (1974).

147. Securities Exchange Act of 1934 §§ 13, 15(d), 15 U.S.C. §§ 78m, 78o(d) (1970). The CBOE is exempt from the reporting requirements. SEC Securities Exchange Act Release No. 10,483 (Nov. 7, 1973); SEC Securities Act Release No. 5444 (Dec. 13, 1973), 39 Fed. Reg. 1283 (1974), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,602, at 83,616. Thus, proposed rule 238 does not apply to CBOE options.

Options Regulation

appear to restrict the number of writers per endorser and the number of endorsers per writer, because aggregate sales must not exceed the rule's limit. This apparent ceiling on the permissible number of endorsers and writers is probably artificial, however, inasmuch as small premiums permit enormous trade volumes before reaching the \$500,000 gross sales level. The proposed rule's requirement that a registered dealer endorse the option to qualify it for exemption might destroy the over-the-counter options market by inducing dealers to endorse the more stable exchange options.¹⁴⁸ The collapse of the over-the-counter market might not seriously affect total options market volume, but it would severely limit the number of stocks represented by exchange options. On balance, however, the rule 238 exemption would likely remove needless restrictions from some options transactions and generally expedite registration procedures. Because an issuer must register on the exchange that trades his security,¹⁴⁹ rule 238 also raises the possibility of double registration. Without an exemption, the SEC would probably compel an exchange to register both the options and the underlying security, because the issuer, for example, the CBOECC, is also the vehicle through which purchasers exercise options.¹⁵⁰ An amendment to rule 12a-6,¹⁵¹ directed especially at options exchanges, exempts the underlying security in situations in which (1) the issuer registers the option, (2) the exchange deals in the underlying stock only when exercising the option, and (3) the issuer of the underlying stock has registered it elsewhere. This rule effectively eliminates all exchange double registration problems.

IV. Margin Requirements

Although the SEC regulates the securities industry to protect the investor, Congress authorized the FRB to regulate the amount of credit that a lender may extend for securities trading,¹⁵² to prevent a misallocation of the nation's credit resources into a speculative securities market.¹⁵³ The FRB has adopted several rules¹⁵⁴ regulating margin,

148. See Frankhauser, *supra* note 146.

149. Securities Exchange Act of 1934 § 12(a), 15 U.S.C. § 78l(a) (1970).

150. Prospectus, *supra* note 15, at 22-26.

151. 17 C.F.R. § 240.12a-6 (1974); see SEC Securities Exchange Act Release No. 10,123 (April 26, 1973), 38 Fed. Reg. 11,448 (1973), [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,354.

152. Securities Exchange Act of 1934 § 7, 15 U.S.C. § 78g (1970).

153. HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, SECURITIES EXCHANGE BILL OF 1934, H.R. REP. NO. 1383, 73d Cong., 2d Sess. 7 (1934).

154. Regulation T, 12 C.F.R. § 220 (1975), governs credit extended by brokers; Reg-

a credit device that enables customers to purchase securities for a percentage of the purchase price. By means of this "down payment," the purchaser becomes equitable owner of the security, which remains in the lender's possession. The borrower never pledges payment of the balance; instead he must continue to match fluctuations in the "down payment" percentage caused by FRB rule changes.¹⁵⁵ The purchaser also must pay interest on the amount of the purchase price balance borrowed from his broker, but he need not pay the principal unless he desires physical possession of the shares.¹⁵⁶ Under Regulation T, the customer may have two accounts—a general, or margin, account,¹⁵⁷ and a special, or nonmargin, account.¹⁵⁸ Registered and exempt securities in the general account have a loan value based on a percentage of their current market value. The customer must maintain sufficient cash and loan value in the general account to cover the "down payment" on his margin securities. Unavoidably, loan value may sink below the proper level because of the effect of market fluctuations on the value of securities in the general account. Accordingly, failure to restore the "down payment" level within five business days after notification by a margin call¹⁵⁹ authorizes the broker to sell sufficient securities in the general account to restore compliance with the margin requirement.¹⁶⁰ In contrast, the special account enables the broker to extend credit on the security's full purchase price for seven business days, after which the customer must pay the full purchase price.¹⁶¹

The FRB recently listed four limitations on the use of options in the margin context:¹⁶² options have no loan value; they are not unissued securities; they may not serve as exchangeable securities in short sales; and they may not be used for arbitrage. Through these rulings the Board effectively discriminates between options and other

ulation U, 12 C.F.R. § 221 (1975), governs credit extended by banks; and Regulation G, 12 C.F.R. § 207 (1975), governs credit extended by other lenders.

155. 12 C.F.R. § 220.3 (1975).

156. *Id.* § 220.3b-2.

157. *Id.* § 220.3.

158. *Id.* § 220.4.

159. A margin call notifies the customer that the loan value of his general account has less value than the current FRB margin requirement for the shares he bought on margin.

160. 12 C.F.R. § 220.3e (1975).

161. A customer who attempts to use the special account to avoid the margin requirement by buying and selling the stock within the seven-day period without depositing the full purchase price may not again use his special account for ninety days. 12 C.F.R. § 220.4c8 (1975).

162. 12 C.F.R. § 220.126 (1975).

Options Regulation

securities and unfortunately misses an opportunity to appraise options in margin accounts on an experimental basis.

A. Loan Value

The FRB, acting to prevent speculation leading to a volatile options market or to a disruption of the underlying securities market,¹⁶³ determined that puts and calls have no loan value.¹⁶⁴ The old margin requirements emphasized that loan value could derive only from exempt and registered securities,¹⁶⁵ in addition to any over-the-counter securities approved by the FRB.¹⁶⁶ Before the birth of the CBOE, puts and calls fell outside this category. CBOE options, however, are registered securities and merit loan value like any other security.¹⁶⁷ The FRB's disparate treatment of options may evolve from the possibility that exchange options would generate double leverage if assigned loan value. Even without the margin benefit, options procure the speculative use of the underlying stock at a cost much less than that required for an investment in the stock itself. If options were marginable, an even smaller capital outlay would generate profit or loss on the underlying stock's price fluctuations. Double leverage would undoubtedly attract investors and make exchanges more attractive to the large institutions that generally disdain options writing because of the small volume. On the other hand, the FRB does not favor extending credit

163. See Gates, *supra* note 2, at 457.

164. 59 FED. RESERVE BULL. 448-49 (1973); Regulation G, 12 C.F.R. § 207.5(a) (1975); Regulation T, 12 C.F.R. § 220.8(f) (1975); Regulation U, 12 C.F.R. § 221.4(a) (1975). The FRB's authority over credit for securities extended by banks stems from the Securities Exchange Act of 1934 § 7(d), 15 U.S.C. § 78g(d) (1970), which grants power only over "equity securities," as defined in the Securities Exchange Act of 1934 § 3(a)(11), 15 U.S.C. § 78c(a)(11) (1970). The FRB had doubted whether options were "equity securities." In light of the emergence of the CBOE, the SEC clarified the issue by amending rule 3a11-1 to include puts and calls within the definition of "equity security," to emphasize that the FRB had power to regulate the extension of options credit by banks. 17 C.F.R. § 240.3a11-1 (1974); SEC Securities Exchange Act Release No. 10,129 (April 27, 1973), 38 Fed. Reg. 11,449 (1973), [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,356; SEC Securities Exchange Act Release No. 9929 (Jan. 29, 1973), 38 Fed. Reg. 3339 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,196.

165. See 59 FED. RESERVE BULL. 448 (1973).

166. 12 C.F.R. § 220.2(e) (1975).

167. See Gates, *supra* note 2, at 456. CBOE options clearly come within the definition of "equity security." See Securities Exchange Act of 1934 § 3(a)(11), 15 U.S.C. § 78c(a)(11) (1970); SEC Securities Exchange Act Release No. 9929 (Jan. 29, 1973), 38 Fed. Reg. 3339 (1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,196. Regulation T adopts this definition, 12 C.F.R. § 220.2(h) n.2 (1975), and includes these securities within the general account, 12 C.F.R. § 220.3(a) (1975).

to foster speculation. The Board has acted in the past to restrict speculation,¹⁶⁸ and the speculation precipitated by the novelty of an options market may subside in part because of the FRB's refusal to attach loan value to options.

The decision to deny loan value was unwise in that it represents an inconsistent application of a possibly unjustifiable proscription. The FRB cannot convincingly support its claim that buying options on margin affects the volatility of the options market¹⁶⁹ or the underlying securities market.¹⁷⁰ The CBOE's experimental stage posed the ideal opportunity for testing the effects of buying options on margin; at present, the volume, the number of investors, and the number of underlying stocks are all relatively small, so that any double leverage adversities have little long-range effect. Arguably, the FRB and the SEC have both decided to exclude margin considerations from the options experiment in order to assure more accurate experimental results. At any rate, the deficiencies caused by administrative failure to estimate economic effects properly are not irreparable, and the FRB can still reconsider and permit options purchases on margin.

The FRB decision to deny loan value to options, however, registers unfavorably for another reason. The no-loan policy logically conflicts with the FRB's treatment of listed warrants—the rights issued by a corporation to acquire its securities¹⁷¹—that the FRB interprets as having loan value.¹⁷² Exchange calls will probably play no greater part in generating speculative fever than listed warrants, even though there are many more calls than warrants to trade. Furthermore, puts

168. See 48 FED. RESERVE BULL. 840 (1962).

169. The commodity futures market treats the "underlying security" as a commodity; otherwise it evinces the same characteristics and volatility as the options market. In the futures market, however, the customer actually buys or sells the commodity for future delivery. The commodity broker may, without FRB interference, extend credit to his customer. See Commodity Exchange Act § 4d(2), 7 U.S.C. § 6d(2) (1970); 17 C.F.R. § 1.30 (1974). Puts and calls of futures are forbidden. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, § 402 (Oct. 23, 1974), amending 7 U.S.C. § 6c (1970).

170. Some listed warrants, and select over-the-counter warrants, both of which resemble call options (except that they are usually of longer duration), may be purchased on margin accounts. See 12 C.F.R. § 220.3(c)(3) (1975); 2 CCH FED. SEC. L. REP. ¶ 22,210, at 16,109 (1974). No disruptive effects have been traced to double leverage.

171. 17 C.F.R. § 240.12a-4(a)(1) (1974). See also *Miller v. General Outdoor Advertising Co.*, 223 F. Supp. 790, 794 (S.D.N.Y. 1963); 17 C.F.R. § 240.12a-4(a)(1) (1974).

172. 12 C.F.R. § 220.3(c)(3) (1975).

It must be noted, however, that the period during which warrants may be exercised is typically much longer than the time usually allowed for options. Warrants are therefore somewhat less speculative.

Options Regulation

and calls are the only specific type of security lacking loan value in a general account.¹⁷³ From the viewpoint of an options customer who wishes only to invest in the secondary options market and not exercise the option,¹⁷⁴ little difference exists between an exchange's option and any other security, aside from the option's smaller price. Because most options traders invest on a small scale,¹⁷⁵ the FRB's discrimination between options traders and traders of other securities favors the wealthy. Although the rule may succeed in limiting the losses of small traders who succumb to ill-advised gambling, margin calls provide a better and less restrictive method. The Board has found no evidence that an infusion of numerous small investors—lured into the market by the prospects of double leverage—will increase speculative fever. Conceivably, the Board is keying on the inability of some customers to pay the option's price upon expiration. Margin calls eliminate potential damage caused by defaulting customers, inasmuch as brokers may sell the options while the account's value level sufficiently covers the obligations. Because the FRB allows customers to buy the options through a special account,¹⁷⁶ essentially an extension of short-term credit, the Board apparently does not view customer default as a primary concern. Accordingly, no justification emerges for the Board's interdictory policy, which amounts to an unauthorized encroachment on the SEC's province of protecting investors.

B. Unissued Securities

The Board has also determined that an option is not an unissued security. The payment period—seven business days for a special account—does not commence until after the writer issues the security.¹⁷⁷ For the first sale of an exchange option, the option may be technically unissued because writing precedes issuance. A few days' delay is common. The FRB demurred from extending the credit period on the basis of such a technicality,¹⁷⁸ ruling that puts and calls do not qualify as unissued securities.¹⁷⁹ Though probably beneficent, the Board's

173. 12 C.F.R. § 220.8(f) (1975).

174. The majority of option traders do not intend to exercise their options. Wax, *SEC Focused Anew on Options Trading*, 219 COM. & FINANCIAL CHRONICLE, Jan. 28, 1974, at 2, col. 2.

175. See Berton, *supra* note 1, at 25.

176. 12 C.F.R. § 220.126(b) (1975).

177. *Id.* § 220.4(c)(3).

178. See *id.* § 220.118 (mutual funds).

179. *Id.* § 220.126(c).

rationale lacks clarity. It may indeed prove difficult to ascertain the beginning of the seven-day period, but the determination seems irrelevant. The FRB can discipline a customer who takes advantage of issuance delay and violates the margin rules by withdrawing from the transaction before the end of the period by imposing a ninety-day freeze on the customer's account.¹⁸⁰ The FRB may have formulated the rule to protect its no-loan provisions: if options were treated as unissued securities, options investors could obtain short-term credit over a long and indefinite period and effectively bypass the no-loan rule. Furthermore, the FRB customarily denies credit usages in primary markets, which deal exclusively in unissued securities.¹⁸¹ The options market, however, presented the curious admixture of both issued and unissued securities, in response to which the Board elected to abjure the secondary characteristics in favor of treating options exclusively as a primary market that traded solely in unissued securities. In the hybrid options market it is more difficult to determine whether a particular customer's option is new, issued, or unissued. The FRB's refusal to classify options as unissued securities, therefore, effectively liberates brokers and the clearing corporation from plaguing technical distinctions.¹⁸²

C. *Exchangeable Securities in Short Sales*

The FRB decided that calls do not qualify as securities, at least in the same sense that some securities may be exchanged for other securities in margin accounts for short sales.¹⁸³ The broker may, on general account, accept exchangeable securities, including warrants, in lieu of the margin requirement for short sales,¹⁸⁴ inasmuch as these securities entitle the holder to the same type of securities as those sold by the short seller. The FRB's position again differs from its stance on warrants. The use of calls rather than securities—*e.g.*, in "against the box" trades, when the sale and purchase of the same type of securities are not cancelled out—requires a much smaller cash commitment and of course extends leverage. Consequently, a ruling that calls are not exchangeable securities apparently furthers the FRB's stated pur-

180. See *id.* § 220.4(c)(8).

181. See *id.* § 220.118.

182. In exercising an option, the CBOECC selects a writer at random. Prospectus, *supra* note 15, at 8.

183. 12 C.F.R. § 220.126(d)-(e) (1975).

184. *Id.* § 220.3(d)(3).

Options Regulation

pose, preventing traders on the short side from exerting more influence than traders on the long side for the same amount of funds.¹⁸⁵ Permitting investors to use warrants as exchangeable securities, however, runs counter to the treatment of options, and the FRB should have extended the benefits to both warrants and calls. Identifying warrants as exchangeable securities might suggest that the FRB intends the rule as a guarantee that the short sale will be covered, except that both warrants and calls already serve that purpose. The real aim of the rule must be to foreclose options' loan value.

D. Arbitrage

The FRB prohibits the use of options for arbitrage. The arbitrage rule—as it relates to a given security, or its counterpart, if convertible within ninety days—allows the purchase of the security in one market, and the sale in another market, without necessitating additional margin payments.¹⁸⁶ Ideally, the rule enables a customer to take better advantage of price differentials on the two exchanges. Frequent use of arbitrage thus stabilizes the price¹⁸⁷ by fostering uniformity among the various exchanges. Read literally, the rule could apply to options, but the FRB has dictated differently,¹⁸⁸ reasoning instead that options customers would use the procedure as a device for hedging,¹⁸⁹ and that any benefits would accrue solely to individual investors, not to the market as a whole.¹⁹⁰ Again, however, the FRB permits the customer to use warrants for hedging and arbitrage purposes.¹⁹¹ Furthermore, the arbitrage technique would carry limited utility in the underlying

185. 12 C.F.R. § 220.126(e) (1975). The FRB surmises that subjecting both long and short transactions to the same rules would create a market decline. Consequently, in an attempt to impede short selling and encourage buying long, the Board has imposed various restrictions, such as permitting short sales only in a market in which the last sale was for a price higher than the preceding sale.

186. *Id.* Ordinarily, such a transaction involves a purchase on one exchange and a short sale on the other. Without the rule, a customer would have to fulfill the margin requirements at both exchanges; under the rule, he need only sustain the margin requirement for one transaction and need not provide additional funds to match the margin requirement at the other exchange.

187. 12 C.F.R. § 220.126(f) (1974).

188. *Id.*

189. Hedging is a trading strategy designed to yield income regardless of the direction of market fluctuations. For example, if a shareholder suspects the market will rise, he purchases a put at the current striking price. If the stock appreciates, he lets the put expire and sells the stock. If the price falls, he exercises the put. The cost of this flexibility is the price of the premium.

190. 12 C.F.R. § 220.126(f) (1975).

191. *Id.* § 220.4(d).

market: unless the premium were less than the difference between the striking price and the current market price, which is uncommon, the increased premium expense would discourage many investors, inasmuch as trading in the underlying security would involve less expense. Arbitrage in options trading would clearly stabilize options prices; options arbitrage thus serve a legitimate function in the options market. Moreover, the investor cannot use the technique to evade margin requirements because, in taking advantage of the price differential, the two transactions would always cancel. The customer can succeed in this plan only by exercising the option, which requires payment of the full purchase price.¹⁹²

V. Conclusion

Recently the securities regulatory agencies have initiated vigorous implementation of the congressional mandate to protect the public and the economy. The resulting paternalism has manifested itself in numerous recent securities developments. Two circumstances have equipped the options market as the most suitable laboratory for testing the SEC's newest ideas in experimental reform: the market probably needs the SEC's guardianship, and, additionally, options trading is so new that resistance to the SEC's intermeddling is somewhat unorganized and underfinanced. Most SEC activity has been designed to protect investors, only the most knowledgeable of whom are commonly able to trade options to their own advantage. The SEC adopted rule 9b-1 so that the Commission could properly supervise formulation of options exchanges' rules, then declared that options qualify as securities so that disclosure would accompany options registration and, finally, proposed rule 9b-2 so that prospective purchasers would know, in advance, about certain dangers in options trading. Meanwhile, the FRB peremptorily withdrew options from the credit market by preventing their use in margin accounts and likewise withdrew options from the securities market by disallowing their use in covering short sales and arbitrage.

In its haste to protect investors, the SEC drafted an options regulation plan containing several faults. First, rule 9b-1 fails clearly to vest the SEC with proper authority to initiate rule changes subsequent to its approval of an exchange's initial trading plan. The rule's language

192. See *id.* § 220.126(b)(2).

Options Regulation

might create loopholes that leave the SEC powerless to intervene with the spontaneity necessary to monitor its experimental regulatory scheme effectively: as a condition to SEC supervision of the approved plan, the rule may instead require affirmative exchange action in amending its initial plan. Second, proposed rule 9b-2 fails to guarantee needed risk disclosure to the customer before he commits himself to the trade. An unscrupulous broker may disclose scanty information before the beginning of the forty-eight-hour period and reveal the required balance of information in a supplemental statement issued at the latest possible moment, when the customer has no opportunity to benefit from the disclosure. Third, proposed rule 9b-2 would not arm the broker with a clear standard for determining whether an options trade is suitable. The broker must ascertain whether the customer understands the options trade, but the standard of reasonableness is vague and may necessitate judicial clarification.

The SEC's new rules suggest that the agency may view the options market as a proving ground for untried theories of exchange regulation and investor protection. By intruding into a market conspicuously lacking powerful, entrenched interests, the SEC perhaps is calculating the precedential leverage that will facilitate later incursions into the securities industry. The SEC may anticipate applying its investor-protection latitude to a wide variety of securities fields. The SEC desires not only that brokers provide information to customers, but also that they provide the information in such a manner that it is instructive to customers before they make trading decisions. Congress likewise intended this effect, but the securities industry has successfully forestalled any SEC move to effectuate the congressional policy on the basis that the disclosure requirement should not inhibit timed trading. The options market might present the SEC's ideal context for testing the disclosure requirement's feasibility before applying it in other securities areas. To meet Congress' mandate of protecting investors, the SEC has augmented its previous disclosure requirements by requiring that investors must also be capable of evaluating the supplied information. In addition, for especially risky options transactions, the SEC will experiment with a rule requiring that the investor actually understand before he trades. If the experiment succeeds and does not inhibit trading, the SEC may extend the requirement to its other suitability rules. Although the SEC's role is undeniably paternalistic, the Commission has refused to protect investors to the extent of banning all options trading. Instead, to encourage the steady growth of options trading and create

a healthy ambience for investors, the Commission maintains appropriate safeguards and, at the same time, preserves the high profit yield of options leverage.

In contrast with the SEC's flexibility, the FRB has responded to options with rigid prohibitions. Rather than drafting thoughtful, protective devices to make certain the proper use of options in margin accounts, the Board has favored a sophistical interpretation that calls are not securities, even though warrants, essentially similar to calls, are securities. Similarly, the FRB has excluded the call from covering short trades and arbitrage maneuvers, although it has not rejected similar uses of warrants. Hopefully the Board will eventually reconsider the Regulation T options philosophy, an unlucky provision that runs counter to the SEC's recent strides in regulating options. The same two considerations that urged SEC action, both of which reflected the need to generate revenue during the recent, depressed economic period, may also activate the FRB. First, the brokerage industry needed increased revenue from commissions on trades. Extensive options trading practically guarantees commission revenue to the brokerage industry by offering high returns to investors at a low capital outlay and thereby attracting an increased and varied clientele that would not ordinarily trade in conventional securities. Second, high-volume trading encourages options writing by large institutional investors in need of additional revenue to offset low dividends and portfolio losses. By isolating new traders from effective credit channels, the FRB has withdrawn a large portion of the market's business and partially thwarted the efforts of the SEC. Options deserve treatment appropriate to modern investment times, including carefully scrutinized incorporation into margin accounts, and use of short sales and arbitrage procedures.